OFFICE OF INSPECTOR GENERAL

U.S. Department of Energy

AUDIT REPORT

OAI-FS-17-06 JANUARY 2017

MANAGEMENT LETTER ON THE FEDERAL ENERGY REGULATORY COMMISSION'S FISCAL YEAR 2016 FINANCIAL STATEMENT AUDIT

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

December 7, 2016

Federal Energy Regulatory Commission, and
The Department of Energy, Office of Inspector General

Ladies and Gentlemen:

In planning and performing our audit of the financial statements of the Federal Energy Regulatory Commission (the Commission or FERC), as of and for the years ended December 31, 2016 and 2015, in accordance with auditing standards generally accepted in the United States of America, we considered the Commission's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the Commission's internal control. Accordingly, we do not express an opinion on the effectiveness of the Commission's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. During our audit we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies and are summarized in Exhibit A.

Our audit procedures are designed primarily to enable us to form an opinion on the financial statements, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the Commission's organization gained during our work to make comments and suggestions that we hope will be useful to you.

The Commission's responses to our communication of the deficiencies identified in our audit are described in Exhibit A. The Commission's responses to our findings and recommendations has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

We would be pleased to discuss these comments and recommendations with you at any time.

This communication is intended solely to describe the comments and recommendations intended to improve internal control or result in other operating efficiencies. Accordingly, this letter is not suitable for any other purpose.

Very truly yours,

KPMG LLP

Enclosure

INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

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CURRENT YEAR FINDINGS AND RECOMMENDATIONS

Documentation Supporting Management's Estimate for Allowance for Doubtful Accounts
(Finding 16-FERC-01)

Background:

As part of the Federal Energy Regulatory Commission's (Commission) role as an enforcer of regulatory requirements, it has the authority to issue orders in which a disgorgement of profits and/or a civil penalty is imposed and then collected as a custodian. For those penalties that are not collected per the terms of the Commission's Order, management determines which cases should be included in its Allowance for Doubtful Accounts by individual account analysis.

Criteria:

Office of Management and Budget (OMB) Circular A-123, *Management Accountability and Control*, Section II states, "Management is responsible for developing and maintaining internal control activities that comply with the following standards to meet the above objectives: control environment, risk assessment, control activities, information and communications, and monitoring." Additionally, "The documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* (Green Book), states that "internal controls and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. All documentation and records should be properly managed and maintained."

Statement of Federal Financial Accounting Standards (SFFAS) 39 states that, "events or transactions that affect the basic information or required supplementary information (RSI) sometimes occur subsequent to the end of the reporting period but before the financial report is issued. Some of those transactions and events (referred to as recognized events) require adjustments while others (referred to as nonrecognized events) may require disclosure in the basic information or RSI. Recognized events consist of those events that provide additional evidence with respect to conditions that existed at the end of the reporting period and affect the estimates inherent in the process of preparing basic information and RSI. In evaluating the conditions on which the estimates were based, all information that becomes available prior to the issuance of the financial report should be used. The basic information or RSI as applicable should be adjusted for any changes in estimates resulting from the use of such evidence. Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities will ordinarily require adjustment of the basic information or RSI because such events typically represent the culmination of conditions that existed over a relatively long period of time."

Condition:

As a result of our test work over the Allowance for Doubtful Accounts and discussions with management throughout the audit, we noted a lack of documentation to support the methodologies related to the Allowance account and subsequent events that may impact the Allowance account.

Cause:

Management's methodology for making the estimate for the Allowance for Doubtful Accounts, including considerations of subsequent events that may impact the year-end balance, were not formally documented or maintained by management and were not readily available for examination.

Effect:

There is a risk that without proper documentation of management's methodologies for making an estimate, or of the conclusions reached, that the conclusions may not be supported or others may not reach the same conclusions. Additionally, there is a risk that subsequent events that occur after fiscal year end but prior to the audit report may not be identified and included. These risks could result in a misstatement to Accounts Receivable, net balance.

Recommendations:

We recommend that the Federal Energy Regulatory Commission's Chief Financial Officer work with appropriate personnel to:

1. Properly document the methodology and procedures related to making the estimate for the Allowance for Doubtful Accounts, including considerations of subsequent events, for civil penalty and disgorgement cases; and

2. Perform an inquiry prior to the draft financial statements prepared for the external auditors, as well as another inquiry prior to the audit report date, to ensure any changes to the collectability of cases are properly reflected in the financial statements and/or disclosures.

Management Response:

Concur. The Commission's Accounting Officer will work with the appropriate personnel to ensure the methodology and procedures used to calculate the estimate for the allowance for doubtful accounts is documented. Though the Commission's Accounting Officer currently discusses the collectability of receivables prior to year-end, the Accounting Officer will also work with the appropriate personnel to ensure there are additional inquiries performed on the collectability of receivables prior to the draft financial statements prepared for external auditors and prior to the audit report date.

Manual Journal Entry Controls Are Not Operating Effectively

(Finding 16-FERC-02)

Background:

As an entity of the Federal government, the Commission uses budgetary accounting to facilitate compliance with legal constraints and to monitor its budget authority at the various stages of execution, including allotment, obligation, and eventual outlay. The United States Standard General Ledger (USSGL), issued by the Department of the Treasury, provides a uniform chart of accounts and technical guidance for standardizing federal agency accounting.

Criteria:

GAO's (Green Book), states that "…management designs control activities so that all transactions are completely and accurately recorded."

OMB Circular A-123, *Section I, Introduction*, states, "Management is responsible for developing and maintaining effective internal control. Effective internal control provides assurance that significant weaknesses in the design or operation of internal control, that could adversely affect the agency's ability to meet its objectives, would be prevented or detected in a timely manner."

Further, OMB Circular A-123, *Section II, Standards, Part C Control Activities*, states, "Control activities include policies, procedures and mechanisms in place to help ensure that agency objectives are met. Several examples include: proper segregation of duties (separate personnel with authority to authorize a transaction, process the transaction, and review the transaction)."

Condition:

During our analysis of the budgetary to proprietary accounts, we noted that management did not make the appropriate budgetary entries for $3.2 million that should be associated with proprietary accounts 2190 and 2940. According to USSGL guidance, when these liability accounts are used, a corresponding debit to account 4801 and credit to account 4901 should also be made.

During our journal entry testwork, an entry related to returning the annual appropriation was unsupported. When we requested additional supporting documentation for the journal entry, management identified a formula error in the calculation related to a prior year obligations reversing entry that impacts accounts 3107/5700 and 3106/5730 related to returning the annual appropriation in the amount of $1.3 million.

Furthermore, during our journal entry testwork and discussions with management, we noted a lack of documented policies over the process for recording manual journal entries related to returning the annual appropriation, especially for those instances in which the USSGL guidance issued by Treasury is inconsistent and/or contradictory with the accounting standards for recording appropriations used.

Cause:

Management's controls over the review of manual journal entries are not operating effectively to detect and correct manual entries that are not recorded to the appropriate accounts and are not properly supported by USSGL guidance or other management policies and directives. Further, compensating controls are not being performed timely to detect and correct errors.

Management’s policies over the process for recording manual journal entries related to returning the annual appropriation were not formally documented or maintained by management, and were not readily available for examination.

Effect:

There is a risk that journal entries may be recorded inaccurately causing misstatements in the financial statements or are not appropriately supported. The 4901 (delivered orders) account was understated and the 4801 (undelivered orders) account was overstated by $3.2 million, which caused the UDO disclosure (Footnote 17) to be overstated on the draft financial statements. Additionally, Appropriations Used (3107/5700) and Transfers Out to Treasury (5730) were understated by $1.3 million, and Other Adjustments (3106) was overstated by the same amount on the draft financial statements.

Recommendation:

We recommend that the Federal Energy Regulatory Commission’s Chief Financial Officer work with appropriate personnel to:

1. Strengthen internal controls already in place to ensure that journal entries are recorded properly reviewed and sufficiently supported; and

2. Strengthen internal controls already in place over the reconciliation of the proprietary and related budgetary journal entries so that differences are followed up prior to the preparation of the draft financial statements.

Management Response:

Concur. Management believes the necessary controls over the review of manual journal entries is operating effectively to detect manual entries not coded to the appropriate accounts and not properly supported by USSGL guidance or other management policies and directives. The Commission’s Accounting Officer will work closely with appropriate personnel to ensure they are adequately trained to fully understand the application of the current controls in order to ensure the controls are working as effectively as intended. To further ensure effective application of the current controls, management has documented the process for recording manual entries associated with returning the Commission’s appropriation back to the Department of the Treasury.

Ineffective Controls in Place Over Invoice Allocation and Year-End Accruals
(Finding 16-FERC-03)

Background:

The Commission's financial statements are prepared using the accrual method of accounting, which requires recognition of the financial effects of transactions, events, and circumstances in the period in which they occurred, regardless of when cash is received or paid. As an entity of the Federal government, the Commission also uses budgetary accounting to facilitate compliance with legal constraints and to monitor its budget authority at the various stages of execution, including allotment, obligation, and eventual outlay. Undelivered orders are obligations made by the Commission for services and purchases that have not been received and accepted as of the balance sheet date.

Criteria:

OMB Circular A-123, *Management Accountability and Control*, Section II states that "Management is responsible for developing and maintaining internal control activities that comply with the following standards to meet the above objectives: control environment, risk assessment, control activities, information and communications, and monitoring." Additionally, it notes that "The documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

GAO's Green Book, states that "control activities occur at all levels and functions of the entity" and include "a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security and the creation and maintenance of relation records which provide evidence of these activities as well as the appropriate documentation."

Furthermore, the Green Book states that "internal controls and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. All documentation and records should be properly managed and maintained."

Condition:

During our test work of a sample of 34 undelivered orders and 9 accrued expense items in fiscal year (FY) 2016, we identified the following errors:

- One invoice related to a specific vendor contract in which services were already performed was not appropriately accrued for in FY 2016; and

- One sample related to a vendor with multiple large contracts in which the incorrect line on a purchase order had been used to make an adjustment to the purchase order.

Cause:

We determined that the issued identified occurred, at least in part, because management's internal controls were not operating effectively to ensure that all outstanding invoices are appropriately accrued for and adjustments are allocated and recorded to the appropriate line item (department and class) within the contract.

Effect:

Obligations and disbursement transactions that are not recorded to the correct line items (department and class) per the contract increase the risk that the balance of Undelivered Orders is misstated. The accrued expenses balance was understated by a known amount of $137,299, which projected to $2.7 million as of September 30, 2016.

Recommendation:

We recommend that the Federal Energy Regulatory Commission's Chief Financial Officer:

1. Work with appropriate personnel to strengthen and enforce the policies and procedures that are in place to ensure that obligations are recorded in a timely manner, invoices are applied against the appropriate obligating documents, and all outstanding invoices are captured during the accrual process.

Management Response:

Concur. Management believes the current policies and procedures in place are sufficient to ensure that obligations are recorded timely, invoices are applied against the appropriate obligating documents, and all outstanding invoices are captured during the accrual process. The Commission's Accounting Officer will work closely with the appropriate personnel to ensure they are adequately trained on the application of current policies and procedures to greatly minimize the risk that the balances of Undelivered Orders are misstated.

Accounting for Capital Leases

(Finding 16-FERC-04)

Background:

The Commission entered into a 5-year, lease-to-own contract for the network modernization capital project during fiscal year 2016. The lease was for one base year and four option years. If the Commission chooses not to exercise an option, the equipment will be returned. Otherwise, the Commission will own the equipment at the end of the lease.

Criteria:

OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, Appendix B, provides instructions on the budgetary treatment of lease-purchases and leases of capital assets consistent with the scorekeeping rule developed by the executive and legislative branches in connection with the *Budget Enforcement Act of 1990.* The scorekeeping rule focuses on leases and lease-purchases specifically authorized by law. However, these requirements apply to all lease-purchase arrangements and capital leases, including those arrangements that agencies may enter into under existing general legal authorities and arrangements that are financed through the Federal Financing Bank.

Specifically, Section 1(a) states that "When an agency is authorized to enter into a lease-purchase or capital lease contract, budget authority will be scored in the year in which the authority is first made available in the amount of the net present value of the Government's total estimated legal obligations over the life of the contract. Further, Section 1(d) states that "When the lease agreement contains an option to renew that can be exercised without additional legislation, it will be presumed that the option will be exercised for purposes of calculating the term of the lease and scoring budget authority."

Condition:

During the Commission's discussion and analysis of how to account for the capital lease, management used OMB A-11, Appendix B, to evaluate whether the lease should be scored. Upon not meeting any of the specific scoring criteria management determined that the guidance did not otherwise apply to the requirements, including fully funding the lease at the beginning of the lease term. As such, only the base year was obligated during FY 2016 instead of the total estimated obligations over the life of the contract, including all option years.

Cause:

The issue identified occurred because management did not appropriately apply guidance from OMB A-11, Appendix B, when obligating the capital lease.

Effect:

We determined that the current year obligation was understated by the remaining option years of the contract, approximately $3.3 million. In addition, the liability for the unfunded portion (account 2990) was overstated in the financial statements by approximately $2.5 million, and the capital lease liability (account 2940) was understated by the same amount.

Recommendation:

We recommend that the Federal Energy Regulatory Commission's Chief Financial Officer work with appropriate personnel to:

1. Document discussions and decisions made around unusual accounting situations and underlying transactions, including the considerations made and guidance used to come to conclusions; and

2. Discuss ambiguous guidance or other matters dealing with budget authority with the Office of General Counsel prior to entering into contracts.

Management Response:

Partially concur. Management believes that it properly followed the guidance in OMB Circular A-11, Appendix B, and properly accounted for the capital lease. Per OMB A-11, Appendix B, and Appropriation Law, management believes the Commission is required to fund upfront the minimum lease payments required under the lease. Management believes this amount would equal the cancellation clause amount, which is what the Commission funded. The Commission's legal counsel agreed with management's interpretation of OMB Circular A-11, Appendix B, and the amount of funding required for the capital lease. Moving forward, the Accounting Officer will engage Commission counsel prior to making a decision on policy that involves appropriation law.

Auditor Response:

We appreciate management's response and note that management does not fully concur with our findings and recommendations. KPMG's position remains the same in regards to the OMB guidance, which presumes that all future options will be exercised for the purposes of calculating the term of the lease and determining budget authority over the life of the contract. As such, the finding remains valid.